China’s Ministry of Commerce issued guidelines in March on attracting foreign investment in 2007. According to the guideline, China intends to continue to encourage foreign investment in research and development (“R&D”) centers. This paper examines intellectual property (“IP”) strategy and best business practices for research and development services in China. Such services are provided in China either by a wholly-owned subsidiary (a wholly foreign owned enterprise (“WFOE”) operating as an R&D center) or by a third party such as for outsourced software development services, integrated circuit design services or contract research in the drug discovery process. Many companies have established a WFOE to be an R&D center in China in order to reduce the costs of and speed up R&D. Advantages of using a WFOE (as opposed to a third party) include that there is more practical control over the results of the R&D and IP can be better protected. A disadvantage is that the parent company also must pay for the infrastructure costs of the WFOE.

CHINA’S INTELLECTUAL PROPERTY INFRASTRUCTURE

Internal Laws

IP protection is implemented in China by statutory protection, written contracts and by “best practices” business policies and actions. The current major China IP laws or statutes are:

- Patent Law adopted March 12, 1984, as amended
- Copyright Law adopted September 7, 1990, as amended
- Trademark Law adopted August 23, 1982, as amended
- Unfair Competition Law adopted September 2, 1993, as amended (includes protection for trade secrets)
- Contract Law adopted March 15, 1999, as amended

Protection provided by a statute is important for an IP owner because it provides protection even if there is no contract in place between parties such as for sales of mass market goods. Statutory protection may be conditioned upon meeting specified requirements such as a patent being issued. Trade secret protection is implemented by contract or a relationship of trust. Patent protection is the strongest type of IP protection because independent development is not a defense to a claim of infringement. Independent development is a defense to a claim of copyright infringement or trade secret misappropriation.

International Conventions

China is a member of all of the major international IP conventions: the World Intellectual Property Organization; Berne Convention for Protection of Literary and Artistic Works (copyright); Universal Copyright Convention; Paris Convention for the Protection of Industrial Property (patent and trademark); Patent Cooperation Treaty; Agreement on TradeRelated Aspects of Intellectual Property Rights and Madrid Agreement for the International Registration of Trademarks. Thus, IP protection is available in China for an individual or entity from a member state of these conventions to the extent a Chinese national’s work would be protected. Trademarks and patents must be issued in China in order to have any protection under the international conventions. Copyright protection does not require registration in China although there is a presumption of ownership and validity if the copyright is registered with the National Copyright Administration.

Enforcement of Intellectual Property Rights

While China has established IP laws that generally meet international standards, weak enforcement continues to frustrate efforts to protect IP in the country. Enforcement of both statutory and contractual protection is a practical problem. Piracy and counterfeiting levels in China continue to be at a high level and impact products, brands and technologies in many types of industries. Judicial and administrative enforcement mechanisms are available but the practical means of protection described in “best business practices” below are very important.
In early April, 2007 the U.S. filed a complaint with the World Trade Organization (“WTO”) in part because of the incidence of copyright piracy and trademark counterfeiting in China. The complaint alleges that China’s weak enforcement of copyright and trademark laws violates WTO’s rules. The low number of criminal prosecutions for piracy and counterfeiting in China is part of the basis for this claim. The WTO will determine whether China has taken sufficient actions to combat such piracy and counterfeiting.

The most feasible legal remedy in China for an IP owner is to attempt to stop IP “leakage” by seeking injunctive relief, that is, a court order directing the persons or entities to stop their infringement or breach of contract. Injunctive relief for a contractual breach (as opposed to infringement of statutory protection for patent, trademark or copyright) is not clearly available in China. Contracts at all levels should provide for injunctive relief to increase the likelihood of a court ordering such relief. Preliminary (or provisional) injunctive relief requires the posting of a bond and strong proof of irreparable harm and prevailing on the merits and, like in the U.S., is considered extraordinary relief which is not easily obtained. There is no equivalent of a “contempt” order in China to enforce a preliminary injunction in the event a court order is disobeyed. There is a means of enforcing a court order for a permanent injunction but a permanent injunction takes much longer to obtain while IP “leakage” may continue.

An IP owner should not expect any significant monetary recovery in a court case in China. It takes about 4-7 years for a lawsuit to be heard in China and the dollar amount of any monetary damages is small. For example, Article 25 of China’s Unfair Competition Law permits the relevant control and inspection authority to award up to $25,000 for misappropriating trade secrets. Thus, monetary remedies do not provide a meaningful deterrent because of the time to recover and the relatively low amounts of recovery.

Administrative remedies are also available in China but only for obvious and literal copying or counterfeiting of goods. In addition, the administrative fines in such cases are not large enough to be an effective deterrent. According to the U.S. Trade Representative, the U.S. trademark and copyright industries continue to report that administrative fines are too low to provide a deterrent, and as a result, infringers continue to consider administrative seizures and fines as a cost of doing business.

R&D SERVICES CONTRACT

Selecting a trustworthy business partner in China for R&D services is a practical way to reduce IP risk. This applies to selecting a third party service provider as well as the management team of a WFOE. A prospective business partner should be carefully investigated on the basis of its track record in both IP protection and contract performance (quality and timing of deliverables) in prior contracts and on their internal physical, electronic and other security controls for protecting IP and confidential information. A trusted partner should have a clearly communicated policy on protecting IP and its actions must be consistent with the policy. Trusted management is needed for day-to-day oversight and execution even though the parent company owns the WFOE.

There must be a services contract with the services provider regardless of whether the WFOE or third party model is being used. Use of a contract with a WFOE is important to the parent for tax and insulation from liability purposes as well as for ownership of IP. The WFOE is a separate legal entity and the parent does not have ownership of IP merely because it owns the WFOE. The parent company needs to make sure it owns the results even when the service provider is its WFOE. The obligations in the services contract must also flow down into contracts with the service provider’s employees and subcontractors.

The key provisions of a typical R&D contract are as follows with emphasis on IP related provisions. Differences between a contract with a WFOE and a third party are noted.

- The China service provider agrees to perform R&D services according to a statement of work. The statement of work may include a specification for the work to be done, schedule for completion of the work, a list of deliverables and a payment schedule. The purpose of such a provision is for both parties to define what is to be done, when it is to be done and what deliveries must be made. Contracts with a WFOE tend to be less specific as to R&D performance and may be simply to provide services as directed by the parent.

- Payment provisions with a WFOE are usually a cost plus profit approach while third party payment schedules may be based on achieving R&D milestones. Some third party service providers may try to make assignments of IP ownership contingent upon receiving full payment for the services.
Third party services contracts usually have acceptance provisions, performance warranties and maintenance service levels while contracts with a WFOE generally have softer or no such requirements. The purpose of these provisions is to assure that the party paying for the services obtains a specified level of performance quality in the results of the services.

The service provider agrees to IP warranty and indemnification contractual provisions, in some cases with qualifiers (knowledge only) or limited scope (U.S. and China IP law only). These provisions are for the purpose of causing the service provider to manage the R&D process to reduce the risk of IP infringement and trade secret misappropriation and to provide a remedy in the event the service provider’s deliverables infringe or misappropriate someone else’s IP. These will be difficult or impossible to fully collect on but may have a deterrent effect and create a more disciplined R&D process.

The service provider agrees to keep specified information as confidential, including any IP and business information as well as the results of the services, and to use such information only for the purpose of providing the services. A confidentiality provision needs to address non-use as well as non-disclosure to effectively protect IP.

The service provider assigns ownership of all intellectual property developed or created under the contract to the party paying for it. The assignment provision is discussed in more detail below. The R&D services produce data, processes, methods, and other confidential information that may not yet be patentable, but that need IP protection. IP developed by the WFOE is usually assigned to the parent in the R&D contract since the parent is the primary liquidity vehicle where value is to be concentrated and customer relationships are directly with the parent. The service provider should agree not to subcontract or otherwise use any non-employee service providers to perform the services without prior written consent so that ownership assignment issues don’t become too complex.

The service provider will likely request an exclusion of consequential, special and similar monetary damages and a limitation of liability provision with a cap on total monetary liability. If there is a cap on monetary liability, it should not apply in the case of a breach of an IP warranty or an IP indemnity obligation.

The service provider irrevocably waives and agrees to never assert moral rights. The moral rights contract provision is discussed in more detail below.

The service provider agrees to audit rights (when, under what circumstances, and the extent to which the party paying for the work can inspect the R&D operations in China). The purpose of this provision is to have a right and mechanism for inspecting the physical and electronic work environment of the service provider to evaluate contract performance and determine if best practices have been implemented.

The contract should choose a governing law to provide more certainty to the interpretation of the contract. This is usually the law of the country of the party paying for the work. Chinese IP law, however, such as assignment of ownership requirements will apply as a matter of public policy regardless of the choice of law in the contract. The governing law provision should contain the clause “excluding that body of law known as conflicts of law” in relation to the chosen law in order to avoid an unintended effect.

The contract should provide for binding arbitration as the ultimate mechanism to resolve commercial disputes. The right to obtain injunctive relief for IP leakage needs to be expressly excluded from the obligation to arbitrate. China is a member of the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the “New York Convention”). Arbitration awards are supposed to be recognized by member countries of the New York Convention. For example, an arbitration award in the U.S. is supposed to be enforceable in China. China’s enforcement under the convention has been spotty at best.

**ASSIGNMENT OF OWNERSHIP PROVISIONS**

Unless certain written assignments are obtained, the party paying for the work may not own the results of the work of the service provider (WFOE or third party) even if it paid for them. The following chart summarizes and compares ownership assignment requirements in China and the U.S. for both employee and independent contractor relationships. A WFOE is treated as an independent contractor not an “employee.” The factors in the columns from left to right address these issues:
(1) whether a written assignment made prior to the completion of the R&D results is effective or if a second written assignment is needed after completion of the R&D results;

(2) the geographical scope (country-wide only or worldwide) of the assignment;

(3) if there is any obligation to exercise the rights assigned; and

(4) the duration or time period of the assignment.

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<thead>
<tr>
<th>Ownership status if no contract</th>
<th>EMPLOYEE</th>
<th>INDEPENDENT CONTRACTOR</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Following Completion of Work (1)</td>
</tr>
<tr>
<td>China</td>
<td></td>
<td>Not Required</td>
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<td>U.S.</td>
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**MORAL RIGHTS PROVISIONS**

The scope of moral rights of an author is broader in China than in the United States. Such rights are expressly provided under Chinese copyright law unlike in the United States. An author’s moral rights include the right of publication, to retain the integrity of the work and to claim authorship of the work. The integrity of a work is infringed if the work is either distorted, altered or otherwise modified to the prejudice of the reputation of the author. The moral rights belong to the author even if a work is created pursuant to an author’s employment and the employer owns copyright in the work. Moral rights may not be assigned by an author but may be waived in whole or in part. An assignment provision does not by itself constitute a waiver of moral rights. Contracts with employees and other service providers need to contain an express irrevocable waiver of moral rights and an obligation not to assert such moral rights.

**BEST BUSINESS PRACTICES FOR IP PROTECTION**

A company that desires to have R&D done in China should establish a corporate IP protection strategy and best business practices which includes the actions below. Most of these business practices are helpful for IP protection generally not just in China. Continuing due diligence will help reduce the risk of IP leakage.
- Make IP protection a primary responsibility of the entire China management team not just legal counsel. Everyone needs to buy into the importance of such protection.

- Register IP rights in China. No patent or trademark protection is available until the patent or trademark is issued in China.

- Separate components of key R&D work so no one group of service providers or work location has access to the complete product or process.

- Check the security processes (physical and electronic), policies and training, employee retention rates and financial status of a third party service provider. Training should include on IP protection. An undercapitalized service provider is more likely to cut corners on IP protection practices.

- Do reference checks on management and key employees of an R&D center. Establish security processes and policies and training for the WFOE. Training should include on IP protection.

- Have WFOE employees sign invention assignment and confidentiality contracts and waivers of moral rights.

- Implement “need to know” levels of access for employees and contractors and establish controls for physical and electronic access to IP based on these access rules.

- Have third party service providers sign contracts that contain assignments of ownership, rights to audit and waivers of moral rights. Make sure such contractors have the proper contracts in place with their employees to implement the company-to-company contract.

- Conduct regular audits of an R&D center and third party service providers to look for vulnerabilities that are causing or could cause IP leakage.

- Keep a close watch on departing employees of an R&D center and the competition to detect IP leakage. Implement a practice of departure interviews and a written reminder to departing employees of their continuing obligations.

**U.S. EXPORT CONTROLS**

A U.S. company should be sensitive to the possibility of U.S. export controls on technology, software and other items that may be needed by its China R&D center or third party service provider to carry out research projects in China. Items needed for research in China should be identified, their export classification determined and any applicable export licenses obtained prior to export. Internal controls over what goes to China should be established, particularly over email communications. This concern is highlighted by the mid-June, 2007 announcement by the U.S. Commerce Department’s Bureau of Industry and Security of changes to the U.S. dual-use export licensing policy for certain high-technology exports to China. New licensing requirements were established on a list of items (products, software and technology) that could contribute to modernization of China’s military forces, including certain lasers, telecommunications equipment and navigation systems. At the same time, individual license requirements for certain authorized customers were eliminated under a validated end-user program for trusted customers (with a track record of responsible civilian use of U.S.-controlled technology). Companies in China that qualify will be authorized to receive certain U.S.-controlled items without individual export licenses.

**CONCLUSION**

Selecting a trusted partner with the right IP business practices and security infrastructure is a practical means of protecting IP in an R&D services relationship in China. This includes selecting the management team of a WFOE as well as selecting a third party contractor. Injunctive relief to stop IP leakage rather than monetary damages is the most realistic legal remedy in China. A patent protecting a product or process must be issued in China in order for the foreign company to seek injunctive relief for patent infringement. Trademark protection also requires issuance of the trademark in China. Injunctive relief is more readily available for patent or trademark infringement than breach of contract. While doing business in China has IP risks, the risks need to be weighed against the economic benefits. China is a market that cannot be ignored. Establishing a practical IP strategy and implementing a set of best business practices consistent with the strategy can help reduce the risk.

*If you have any questions about this memorandum, please contact Fred M. Greguras (fgreguras@fenwick.com) of Fenwick & West LLP.*

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**INTELLECTUAL PROPERTY STRATEGY AND BEST PRACTICES FOR R&D SERVICES IN CHINA**

**FENWICK & WEST**